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International Economic & Energy Weekly

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Dollar depreciation over the past year has wiped out the cost advantage of Japanese and EC steel producers over the US steel industry. The profit picture this year is poor, with probable losses for Japanese producers and a weakening of recent EC gains. Export sales below average cost will further aggravate trade frictions with the United States. 25X1

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Perspective

Brazil: Sarney Takes Control of the Economy

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Buoyed by rising popularity and the outcome of last November's municipal elections, President Sarney has emerged from the shadow of the late President-elect Tancredo Neves and begun to tackle tough economic reform issues. Politically strengthened, Sarney has made increasingly assertive use of the presidency's powers to lessen his dependence on the congressional leadership of Neves's governing Democratic Alliance. Moreover, he reshaped his cabinet to his own liking and reorganized the presidential staff. 25X1

The government's bold new stabilization program—dubbed the Tropical Plan—announced in late February is not only braking Brazil's triple-digit inflation but has proved to be a masterful political stroke. A crucial feature of the plan is the end of the pervasive price indexation system for financial transactions and wages that had been a major impediment to efforts to reduce inflation for more than 20 years. So far, the plan has gained widespread popular backing, prevented a potential splintering of the governing coalition over the political costs of rising inflation, and defused growing labor unrest. The President probably will ease price controls later in the year to avert a recession and thus head off political opposition. 25X1

Also helping Sarney's standing this year is the likelihood of another large external trade surplus that will boost reserves and prevent relations with foreign creditors from becoming a significant campaign issue. Surging coffee revenues and a sharply lower oil import bill—primarily reflecting slumping world petroleum prices—will roughly offset drought-induced losses in the trade balance. 25X1

The likely short-term effects of the Tropical Plan—reduced inflation and continued, though diminished, growth—coupled with a favorable external financial position probably will lead to significant political gains for Sarney in the congressional elections this fall. He will be able to use his political prestige and presidential powers to keep the left off balance—particularly the presidential aspirant, Leonel Brizola, the governor of Rio de Janeiro state—and to stump effectively for moderate politicians for election to the new congress.

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With a newly elected congress solidly behind it, the Sarney administration may take an even firmer grip on economic policy by the end of this year. If prices resurge after controls are eased, Sarney then may be in position to deal with domestic budgetary and monetary excesses that are the more fundamental causes of inflationary pressures. 25X1

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Drought-Stricken States

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Brazil: The Impact of the Drought 25X1

The most severe drought in half a century in Brazil's agricultural breadbasket is finally over, but not before causing considerable damage to the region's crops and sparking record inflation. Crop losses and other drought-related problems will contribute to the likely decline in Brazil's economic growth this year, although sharply higher world coffee prices combined with lower oil prices will largely offset the effect on the 1986 trade balance. Damage to coffee trees and cattle herds, however, will probably impair full production potential in those sectors into 1987 and beyond. The Sarney administration has moved skillfully to minimize political fallout from the drought but may face increased demands for federal aid, which could undermine the stabilization program. Meanwhile, the United States stands to gain up to $1.7 billion in agricultural sales this year as a result of the Brazilian drought.

High and Dry

A five-month drought that began in September 1985 parched Brazil's fertile southern states of Sao Paulo, Parana, Santa Catarina, and Rio Grande do Sul, a region that accounts for 70 percent of GDP. Brazilian agronomists indicate that both export and domestic food crops have been hurt, with the national coffee harvest likely to be down by one-half and crops for local consumption by one-fourth. According to Brazilian press reports, thousands of cattle have died as a result of starvation and dehydration; the US Embassy reports that up to 25 percent of the region's calves have been slaughtered as a result of the drought.

Industrial production also was disrupted because of hydropower shortages. A reduction in the flow of the region's rivers and extremely low storage reservoirs forced local authorities to begin rationing water and electricity in late January. Industry, which accounts for about 40 percent of total electricity consumption in the region, initially had to reduce its use by 15 percent, while business and residential customers suffered cuts of 35 and 45 percent, respectively, according to the US Consulate in Porto Alegre. 25X1

Immediate Shockwaves

The region's farm economy will continue to suffer although rainfall has returned to normal levels. Local press reports indicate many farmers who planted during the September to November sowing season stand to lose nearly their entire crop. Those that were able to replant incurred significant additional costs and will probably obtain lower yields. Numerous small farmers on the verge of bankruptcy have laid off many dayworkers, swelling the ranks of the rural unemployed. Although some are migrating to the cities, others remain in the countryside agitating for land reform. 25X1

US Embassy reporting indicates crop losses caused by the drought, production cost increases, and hoarding by speculators quickly resulted in higher prices for basic foodstuffs in domestic markets, with domestic prices of key staples—coffee and beans—rising most dramatically. Consumers faced average monthly food price hikes of more than 14 percent from December through February, while the shoe industry—which generated nearly $1 billion in export earnings last year—is facing higher prices for leather. Taken together, Brazil's inflation rate increased a record 16.2 percent in January and 14.5 percent in February. 25X1

25X1 Official statistics indicate that basic foodstuffs account for 60 percent of budgetary expenditures by low-income earners. 25X1

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Widespread Drought Losses

While final tallies are not yet in, and damage estimates vary widely, the following estimates are reasonable in our judgment. Among export crops:

- ***Coffee.*** *The Brazilian Government and coffee traders project current production at 15 million bags or less, about one-half the previous harvest, but export volumes probably will be reduced by only one-third (to 14-14.5 million bags) as Brasilia draws on its large stocks.*
- ***Soybeans.*** *A harvest of 12.5 million metric tons is expected, according to various traders, compared with nearly 18 million tons last year, leading to a decline in exports of about one-third.*
- ***Orange Juice.*** *Orange production may drop one-third to 155 million boxes, according to industry sources, but production of frozen concentrate—nearly all of Brazil's exports—will not be as severely affected because substandard fruit can be processed.*
- ***Cotton.*** *Production is estimated to be about 10 percent lower as a result of the drought; exports should not be affected since stocks were high at the beginning of the year.*

Among domestic foods:

- ***Corn.*** *Local agronomists estimate a harvest of 19 million tons, down from almost 22 million last year. Imports of about 4 million tons are expected.*
- ***Rice.*** *Production will be about 5 percent above last year's 8.8 million tons as a result of irrigation of rice fields in the south and a good harvest in the north, according to the Ministry of Agriculture. Imports of about 1.2 million tons are expected to build up government stocks.*
- ***Beans.*** *This key Brazilian staple was the hardest hit—nearly one-half of the first harvest was lost, according to the Ministry of Agriculture. The second harvest should fare better because of recent rains. Imports of at least 50,000 tons are projected.*
- ***Dairy Products.*** *Milk production is already more than 15 percent lower, and is expected to fall even further, as the surviving herd is weaker and producing less, according to the US Embassy. Imports of nonfat dry milk are expected to increase.*

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Sarney Responds

The Sarney administration moved quickly to provide disaster relief. To prevent widespread farm failures, the government made it easier for farmers to renegotiate loans, made the government crop insurance program more accessible, and extended an emergency line of subsidized credit. In one heavily affected state—Rio Grande do Sul—it donated about $1 million to a relief fund for small farms. Most farmers feel these measures are inadequate and are requesting that loans contracted for this crop year be forgiven, according to the US Embassy.

To reduce the national political fallout, the government responded to inflation pressures by selling buffer stocks and attempting to tighten price controls. Press and US Embassy reports indicate, however, that government stocks were inadequate to stem price rises and that additional food imports were required. We believe that the rapid price runups probably enabled the government in late February to galvanize public support for "economic shock treatment," particularly the price freeze.

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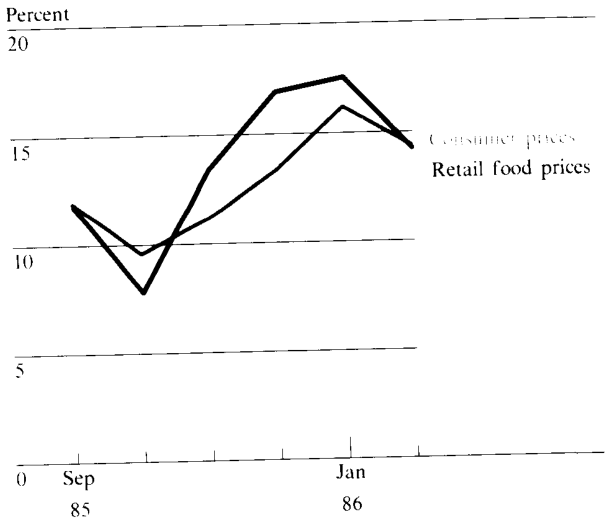
Brazil: Monthly Inflation and Food Price Increases



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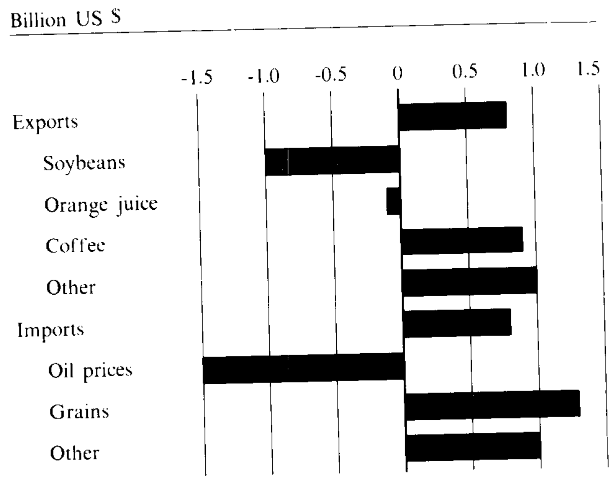
Brazil: Projected Change in Trade Accounts, 1986 [a]



[a] Change compared to 1985 levels.

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Future Economic Repercussions

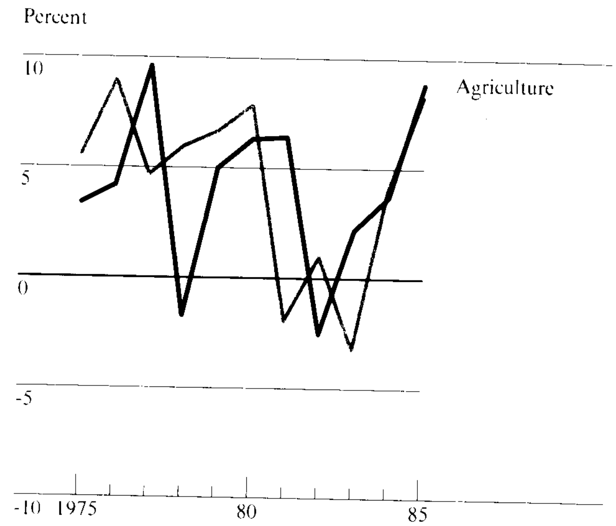
Trade Balance. On the basis of a variety of sources, the drought will cost an estimated $2.4 billion in lost exports and additional imports. Soybean exports are likely to bring in about $1 billion less because of lower export volume, and earnings from citrus probably will decline slightly. On the import side, expenditures for grains probably will rise by $1.3 billion this year as the government attempts to prevent food shortages and to rebuild buffer stocks.

We expect higher coffee prices and lower oil import costs will offset the effect of the agricultural shocks on the trade account this year. Largely because of the Brazilian drought, Brazilian coffee export prices have more than doubled since late last year. With sales from official stocks, coffee export revenues are likely to be up by nearly $1 billion. Moreover, the oil import bill is expected to decline by $1.5 billion because of low world oil prices and domestic production increases. All told, we expect the trade surplus to be roughly equal to last year's $12.4 billion. 25X1

Growth. We believe real national economic growth this year is likely to be 3 to 5 percent compared with last year's 8.3 percent. Industrial production was disrupted for three months, while agricultural output in the drought-affected region, which generally accounts for 60 percent of national crop production, probably will decline at least 10 percent. Favorable weather in the normally arid northeast, however, will help offset some of the losses in the south. We project zero growth overall for the agricultural sector this year. 25X1 25X1

Future Production. The effects of the drought will probably be felt for the next few years. Agricultural experts believe that some coffee trees probably will be lost as a result of the extended dry period,

Brazil: GDP and Agricultural Growth Rates



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and, even if replaced, it will take three years before they begin to produce. Additionally, other coffee trees will be so severely pruned that they will not flower next year, and the dryness has weakened their resistance to frost and insect damage. Moreover, press reports indicate that, unless the government provides additional assistance, some coffee farmers are planning to switch to producing annual crops such as corn and rice. Production of dairy products has been jeopardized by the large loss of cattle, and it is likely to take three years for milk production to reach predrought levels.

Political Ramifications

Pledges of assistance have, in our opinion, limited the immediate political damage to the government in a region where leftist opposition is strong. By introducing the new economic program, particularly the price freeze, Sarney almost certainly avoided a wave of strikes for wage increases in the wake of skyrocketing food prices. Although labor leaders have criticized the program's wage freeze and initially threatened to call a general strike, they backed off after witnessing the broad public approval. Moreover, the import of foodstuffs—highly publicized by the Brazilian media—will help alleviate food shortages and public disgruntlement. 25X1

Although Sarney has moved adroitly to minimize the short-term political fallout from the drought, disaster relief may put the stabilization program at risk. The government probably will be faced with increased demands for public assistance to farmers to help replant crops and replace dead coffee trees. Farmers probably will intensify their demands that crop production loans be forgiven and request emergency donations to compensate for the loss in income, while the landless probably will exert pressure for movement on agrarian reform. Because such demands would most likely occur in the months preceding the important November elections, Sarney would be under considerable pressure to loosen federal purse strings, thereby undermining the fiscal discipline necessary to break triple-digit inflation. Moreover, should the government live up to its promise to build and maintain a 30-day stock of basic foodstuffs for the entire country, Brasilia may again resort to increased printing of money. 25X1

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Implications for the United States

The United States will probably gain some agricultural sales as a result of the Brazilian drought. The Sarney administration has requested an additional $500 million in US credit guarantees to cover import needs, and the Embassy believes US agricultural exports to Brazil could double to $800-900 million in 1986. 25X1

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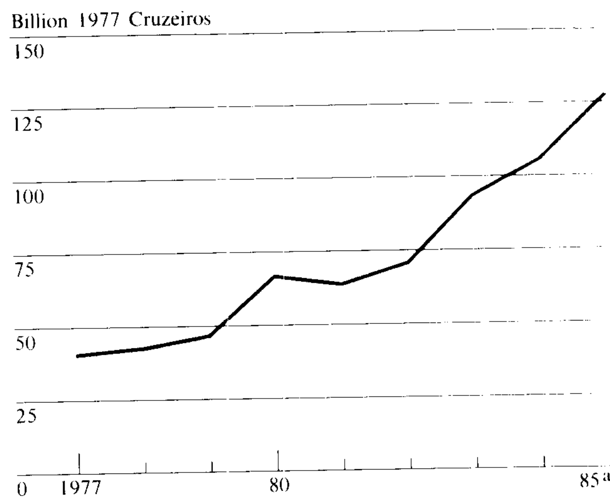
Brazil's Minerals: New Source of Growth [redacted] 25X1

With the development of its extensive natural resources, Brazil is rapidly increasing the production of its extractive industries, providing a boost to domestic economic growth and exports. Although Brasilia forecasts continued investment and expansion in minerals, low commodity prices and investor concern over inflation and government policy intentions may dim this picture. We believe that growth will continue, albeit at a somewhat reduced pace, increasing competition with the United States for third-country mineral sales. [redacted] 25X1

Brazil: Trends in Mineral Output, 1977-85



[a] Estimated.

[redacted] 25X1

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Brazil's Success in Minerals

Brazil's nonpetroleum extractive industries are raising output rapidly, according to US Embassy reports, and provide an increasing contribution to Brazil's economic performance. Official Brazilian statistics indicate the value of mineral output rose at an average annual rate of 15 percent between 1977 and 1985. Consequently, the minerals share of Brazil's GDP is up, from 0.7 percent in 1981 to 2.2 percent in 1985, and the sector now employs about 87,000 people. [redacted]

[redacted] the mineral sector's overall expansion has been led by dramatic production leaps in:

- ***Iron ore***, where production has grown by more than 18 percent in only two years. Exports of 88 million metric tons in 1985 now make Brazil the world's leading exporter.
- ***Bauxite***, production of which is up by more than 55 percent in two years to 6.6 million tons.
- ***Gold***, where output has grown more than ninefold in a decade, mainly from small prospectors mining deposits in the Amazon.
- ***Tin***, production of which, once negligible, now amounts to 24,000 tons—converting an import requirement into an export earner. Brazil's largest tin mine now outproduces Bolivia's tin sector. [redacted] 25X1

A rich resource base and aggressive exploration for new deposits underlie these trends. [redacted] for minerals such as iron, tin, and bauxite the purity of Brazilian reserves exceeds the world average, making development attractive. Brazilian producers, in the last year, have identified significant new reserves of zirconite, coal, bauxite, and gold. [redacted] 25X1 25X1 25X1 25X1

Brasilia also uses an array of economic incentives to support continued expansion of the minerals sector, including accelerated depreciation of domestically produced mining equipment and preferential financing from official credit agencies. To

Brazil: Production of Key Minerals, 1983-85

	1983	1984	1985 [a]
Production *(million metric tons, except where noted)*			
Iron ore	88.7	90.0	105.0
Gold *(metric tons)*	53.7	55.0	61.1
Tin *(thousand metric tons)*	13.0	18.0	21.0
Coal	3.2	1.4	2.2
Bauxite	4.2	5.8	6.6
Limestone	34.9	50.6	60.8
Manganese	2.1	2.1	2.2
Value *(million US $)*			
Iron ore	527	784	914
Gold	1,016	761	845
Tin	157	220	252
Coal	200	182	270
Bauxite	154	159	180
Limestone	190	154	185
Manganese	86	89	93

[a] Estimated.

[redacted]

Brazil: Projections for Mineral Expansion, 1985-88 [a]

	1985	1986	1987	1988
	Million metric tons			
Iron ore				
Production	105	129	139	NA
Consumption	17	17	17	NA
Exports	88	112	122	NA
Bauxite				
Production	6.6	6.6	6.5	6.6
Consumption	2.9	2.9	3.1	3.6
Exports	3.7	3.7	3.4	3.0
	Thousand metric tons			
Aluminum				
Production	606	784	924	924
Consumption	329	345	361	379
Exports	277	439	563	545
Coal, metallurgical				
Production	2,170	2,452	2,433	2,328
Consumption	6,741	7,321	7,951	8,635
Imports	4,571	4,869	5,518	6,307
Copper				
Production	45.0	50.1	57.0	57.0
Consumption	82.1	113.0	133.9	151.9
Imports	37.1	62.9	76.9	94.9
Tin				
Production	21.4	24.0	26.9	30.1
Consumption	20.6	21.9	23.2	24.6
Exports	0.8	2.1	3.7	5.5
Manganese				
Production	1,900	2,015	2,263	2,676
Consumption	1,150	1,232	1,321	1,416
Exports	750	783	942	1,260
Ferro-Columbium				
Production	11.7	12.4	12.9	13.5
Consumption	1.0	1.1	1.2	1.2
Exports	10.7	11.3	11.7	12.3

[a] These figures are projections for mineral sector expansion by Brazil's National Department of Mineral Production .

[redacted]

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encourage private-sector investment, the government has eased customs procedures for advanced technology imports and grants tax exemptions and low electricity rates for company operations. Brazilian law permits foreign investment in mining but encourages joint ventures, and most multinationals, [redacted] obtain a Brazilian partner, who retains a majority interest. [redacted]

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Bolstering the External Accounts

Despite pressures from foreign creditors and domestic critics to cease preferential taxes and financing for parastatals, including the mining sector, Brasilia is unlikely to rein in a sector that is bolstering the current account. Although borrowing for mining ventures has added to the foreign debt, it has promoted import substitution. For example,

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Brazil's Treasure Trove of Minerals

Brazil now claims a significant share of world reserves of strategic minerals. According to industry publications, the country is a major source of the world's columbium (94 percent), beryllium (36 percent), bauxite (12 percent), gold (12 percent), tantalum (9 percent), iron (8 percent), magnesium (7 percent), and tin (4 percent). In contrast, Brazil continues to rely on imports for its metallurgical coal, sulphur, molybdenum, silver, and platinum.

For the United States, Brasilia is a key mineral supplier for a range of industries. Brazil sold 26 minerals worth a total of $78 million to US firms in 1984, mostly bauxite ($28 million) and iron ore ($38 million). Additionally, the country supplies smaller amounts of beryllium, columbium, manganese, quartz, silicon, and tantalum, but these are critical to such manufacturing processes as high-strength steel and exotic metals.

both manganese and aluminum are now steady export earners. Brazil's mineral exports totaled about $2 billion in 1984, according to trade statistics—7 percent of total exports, and the equivalent of 20 percent of annual interest payments on the foreign debt. Exports of iron ore ($1.5 billion), aluminum ($284 million), and tin ($142 million) led sales. Brazilian minerals are marketed worldwide, with Japan ($530 million) and West Germany ($210 million) the two largest buyers.

CVRD—The Major Player

The parastatal Cia Vale do Rio Doce (CVRD) will play a key role in continuing Brazil's recent success in minerals. CVRD is Brazil's largest mining company and is the prototype for mineral development, in terms of profitably exploiting new reserves. CVRD—majority owned by the federal government—provides 11.4 percent of all mining output in Brazil and exported over $1 billion in minerals in 1984. It owns 31 other mining companies, most of them set up to avoid Brazil's law that limits the number of minerals one company can mine to five. Despite its $12 billion debt, CVRD is one of only two large public enterprises operating in the black. 25X1

The Carajas area, in Brazil's north-central state of Para, contains the world's highest purity iron ore as well as extensive manganese, copper, bauxite, nickel, tin, and gold deposits. Brasilia grants special tax and financing treatment to develop Carajas ventures. CVRD's iron ore mines are the largest venture at Carajas. With the World Bank as a cofinancer of the project, CVRD completed a 25X1 railroad to the port of Sao Luis in 1985, opening the way for Carajas' first iron ore exports—1 million tons. Brazilian government projections indicate that extensive infrastructure development, including roads, ports, and communications, will clear the way for 35 million tons of iron ore output per year by 1988. 25X1

To finance future expansion of its Carajas venture, 25X1 CVRD plans to invest another $1.4 billion in 1986-88, according to press and Embassy reports, increasing its total investment to about $5 billion. CVRD has signed contracts to sell 28 million tons of ore to facilitate borrowing from the World Bank and private creditors. For example, the Japanese have signed 10-year contracts worth over $200 million. In addition, CVRD is developing previously discovered manganese deposits and a new find of 50 million tons of bauxite and is pursuing copper exploration. 25X1

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Challenges to Further Expansion

Brazil's National Department of Mineral Production forecasts growth averaging 26 percent for all minerals production between 1985 and 1988, but we believe this estimate is on the high side. New investments of $820 million are planned through 1988 to reach this target. Official statistics indicate, however, that actual investments in new minerals projects decelerated in 1984 and 1985, and

depressed world mineral prices are creating new uncertainty over bringing new projects on line, [redacted] We believe price 25X1
drops between 1981 and 1986, ranging from 12 percent for aluminum to 25 percent for gold and iron ore, are reducing the expected profitability of exports. In addition, investor concern is rising over Brazil's draconian inflation-fighting program because of its stringent price controls and the prospect that it will reduce domestic demands for minerals. Despite some postponed projects we expect that capital investment in minerals production will continue to rise and that the mineral sector will account for about 3 percent of Brazilian GDP by 1988. [redacted] 25X1

Implications for US Trade

Opportunities for US exports of mineral ores to Brazil will continue to decrease, with the exception of coal and sulfur. Competition for US markets, however, will be limited to iron ore—in which Brazil enjoys a large cost advantage—and a few other minerals of low volume. Brazil will continue as a reliable, although low-volume, supplier of several strategic minerals to the United States. Nevertheless, Brazil will compete more strongly with US producers in processed metals—particularly in ferroalloys and aluminum. Brazilian producers will seek markets in the United States and will compete more strongly in third-country export markets. [redacted] 25X1

At the same time, Brazil will offer a declining market for US mining equipment and related service exports. For example, Brasilia allows the mining sector accelerated depreciation only on capital equipment made in Brazil. This buy-at-home policy, along with other import-restricting measures, has already led to a decline in US mining equipment sales from $52 million in 1983 to $4 million in 1984. [redacted] 25X1

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International Financial Situation: Saudi Budget Woes [redacted]

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With little prospect of oil prices stabilizing above $15 per barrel this year and the Saudi asset cushion steadily eroding, Riyadh's options for resolving its FY 1986/87 budget crunch are narrowing. In March, just prior to the start of the fiscal year, the government postponed publication of the new budget and announced that it would take five months to review it. The move permitted Riyadh to defer action on its growing financial problems, and allowed Saudi ministries to continue spending at last year's levels. New sources of revenue are unlikely, leaving the government with the prospect of major spending cuts. Although the government will tailor these cuts to minimize the domestic political impact, intensified economic pressures could lead to hasty, ill-advised choices that might sharply increase domestic criticism of the regime, possibly with anti-US overtones. [redacted]

Drafting a Budget

Mounting deficits and plummeting oil prices are causing the Saudis to reconsider some of the political, economic, and religious policy constraints that have guided the drafting of their austere budgets of recent years. [redacted]

Limiting Domestic Spending Cuts. Although Riyadh has trimmed domestic spending over the past four years, the government has to a large extent spared the populace and important interest groups from the impact of these cutbacks. While most large-scale construction projects have been shelved and payments to contractors stretched out, Saudi citizens have continued to receive most of the benefits to which they have become accustomed. Defense and internal security appropriations also have been protected. With lower oil revenues, however, there will be fewer areas in this and successive budgets where cuts can be made relatively painlessly. [redacted]

Limiting Cuts in Foreign Aid. Riyadh has cut foreign aid during the last few years, but checkbook diplomacy is still an important part of Saudi foreign policy; foreign aid amounted to more than $6 billion last year. Riyadh remains forthcoming to countries it considers important to its national security, and it uses foreign aid to buy protection from terrorism. Although countries of less immediate concern will find it even more difficult to extract Saudi assistance, aid to Iraq, Syria, Jordan, the PLO, Afghan insurgents, Pakistan, Sudan, Bahrain, and North Yemen—recipients of the lion's share of Saudi aid—probably will continue at close to current levels. [redacted] 25X1

Increasing Revenues. Riyadh has attempted to increase and diversify its sources of revenue. Last year it raised customs duties, port charges, and other fees, and resolved to collect *zakat*—an Islamic tax paid annually to support the poor—from all eligible firms. The government has spent over $20 billion developing its petrochemical industry and is aggressively marketing its output to generate income. As part of its Fourth Development Plan, Riyadh has focused on privatization, including the divestiture of several government firms. Despite these efforts, revenues from Saudi investments, fees, taxes, and petrochemical sales provided less than $12 billion last year. With declining foreign investment income, falling customs revenues as imports drop, a limited tax base, and the worldwide petrochemical glut, just matching last year's revenue levels will be difficult, if not impossible. [redacted] 25X1

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Limiting Drawdowns of International Assets. Riyadh has drawn down its foreign asset cushion at unprecedented rates—$50 billion over the last three years, according to the US Embassy—and remaining liquid assets are estimated at about $55 billion. These assets are intended for emergency use

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should Saudi oil exports be cut off. Even if Riyadh can limit asset drawdowns to $10 billion per year—half the recent rate—the cushion would last less than six years. While the oil market is expected to strengthen during that time, the Saudis presumably view such drawdowns as risky. 25X1

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Rejecting International Borrowing. Islamic strictures against the paying of interest so far have precluded international borrowing as an option. Moreover, the Saudis apparently see borrowing as a public indication of economic weakness and vulnerability. According to the US Embassy, there have been persistent local rumors that Finance Minister Aba al-Khayl has investigated the possibility of foreign borrowing while Saudi Arabia's credit rating is still strong. 25X1

No Easy Choices

Given the revenue and expenditure outlook for this year and the constraints Riyadh faces in trying to set economic policy, the government has no easy way out of this year's budget crunch. Assuming oil revenues stabilize at $15 per barrel for the remainder of the year and the Saudis do not exceed their OPEC production quota of 4.3 million b/d, Saudi oil export revenues in 1986 would total about $20 billion. Even if other revenues were the same as last year, total Saudi budget income would fall by 15 percent to about $30 billion. If the government were able to impose a 15-percent across-the-board spending cutback—similar to last year's goal—expenditures would still total $43 billion. The magnitude of this year's projected deficit may force Saudi leaders to act quickly and take greater risks than normal.

Boosting Oil Production. With 10 million b/d of sustainable oil production capacity, the Saudis theoretically could more than double current production in an effort to finance the anticipated deficit. Last September, the Saudis began to unilaterally increase production after it bottomed out at 2.2 million b/d. Riyadh, however, has kept production to 4.3 million b/d—and we doubt that it would boost output again unless demand increases. The Saudis, moreover, are facing relentless pressure from OPEC hardliners—Iran, Libya, and Algeria—to limit production and thus are unlikely to make another provocative oil production move. Moreover, further increases might not lead to substantially higher revenues in the short term because of the additional downward pressure on oil prices. 25X1

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Tougher Spending Cuts. Riyadh will have to make cuts in domestic spending, but Saudi planners will proceed cautiously. The government probably will initially target spending that supports the expatriate labor force—about two-thirds of the total labor force—to minimize cuts directly affecting Saudi citizens. The kingdom is still dependent on foreign workers, however, and Riyadh will be unable to cut sufficient numbers of foreign workers this year to reduce government spending significantly. [redacted]

Foreign Borrowing. International borrowing appears an obvious and less painful option. To conform to Islamic principles, Islamic banks in Saudi Arabia offer loans in return for repayment guarantees plus a charge that covers "administrative" expenses, including interest. The Saudi Government probably could use a similar arrangement to obtain foreign loans while technically abiding by Islamic law. Despite the risk of objections from the religious establishment, we believe the Saudis will soon consider this option seriously. [redacted] 25X1

Tapping Domestic Savings. Riyadh also could seek creative ways to try to harness some of the extensive pool of private assets. The Saudi Arabian Monetary Agency has introduced schemes to discourage capital outflows and mop up excess liquidity in the Saudi economy. Some of Riyadh's privatization efforts are, in part, an effort to capture Saudi savings. Unless the government can find a mechanism to encourage the repatriation of large amounts of capital, however, these efforts will do little to help the economy this year. One option would be to offer dollar-denominated government securities to Saudi citizens at competitive rates. [redacted] 25X6

Outlook

As Saudi budget pressures grow, Riyadh will have few options and will have to take decisive action that could begin to erode the popular support for the regime. Although we believe that the government will attempt to carefully weigh its choices, intensified economic pressures could lead to hasty and ill-advised policy moves that might sharply increase domestic criticism of the regime. US interests probably would suffer because any increase in antigovernment sentiment probably would have an anti-US dimension. [redacted] 25X1

25X1

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Thailand: Wrestling With Foreign Debt Management [redacted] 25X1

Thailand probably can avoid a formal rescheduling of its $18.5 billion foreign debt [1] over the next two to three years through a combination of continued budget austerity and refinancing of some of its short-term liabilities. If such measures are carried out, we expect the debt service ratio to rise only modestly from the record 35 percent registered in 1985 before beginning a gradual decline by the end of the decade. Nonetheless, domestic pressures on Prime Minister Prem's government will intensify as austerity and depressed export earnings slow economic growth, which at 4 percent last year was already the lowest in 20 years. [redacted] 25X1

Thailand: Estimated Foreign Debt *Billion US $*

	Yearend 1985
Total debt	**18.5**
Official	8.8
Short term	0.9
Medium and long term	7.8
Private	9.7
Short term	3.6
Medium and long term	6.1

[redacted] 25X1

Debt Management Difficulties

Although international financial analysts consider Thailand's foreign debt moderate compared with that of many other LDCs, the Prem government over the past two years has become increasingly worried that debt service payments are growing substantially faster than capacity to meet them. These payments have grown from about $2 billion annually in the early 1980s to $3.2 billion in 1985. This represented 35 percent of export earnings for goods and services compared with the 1980 debt service ratio of 21 percent. In the same period, Thailand's foreign debt has grown at an average annual rate of nearly 15 percent, rising from $9.7 billion in 1980 to $18.5 billion last year. [redacted]

Concerned that continued growth of the debt service ratio could jeopardize Bangkok's good international credit rating—and long-term economic prospects—Prem's government as early as 1984 began taking steps to curb external borrowing and to improve the balance of payments. Bangkok cut public-sector foreign borrowing—which accounts for about half of total foreign debt—from $2-3 billion per year in the early 1980s to about $1.6 billion in 1985, and recently lowered its 1986 borrowing ceiling to $1 billion. In late 1984 it devalued and floated its currency, launched an export drive, and stepped up basic economic reforms to boost domestic savings and investment. In addition, Bangkok last year—with the help of a $400 million IMF standby arrangement—undertook a five-year, $1.9 billion, debt-refinancing plan to take advantage of lower interest rates and avoid a bunching of repayments over the next two years. 25X1
Although the refinancing plan—which covers 10 percent of total foreign debt at the end of 1985—was limited initially to public enterprise debt, it has now been expanded to include government debt. [redacted] 25X1

[1] Our estimates of Thailand's external debt are generally higher than those of international financial institutions. [redacted] 25X1

Bangkok's Bind

Prem, in our view, probably will face intense pressure as debt management considerations leave him with little choice but continued austerity. There is little that Bangkok can do to boost export earnings in the current world trade environment, but it undoubtedly will fight to protect Thai exports from rising import barriers in overseas markets. Bangkok also is concerned about the recently enacted US farm bill. Earnings from agricultural exports such as rice—Thailand's leading merchandise export—would suffer if US grain exporters take advantage of the bill's export promotion provisions to increase sales in Thailand's traditional markets.

Debt management measures and a weak export performance will almost certainly increase domestic pressures to back off from austerity. We estimate economic growth this year will slow to about 3.7 percent, representing a further decline from last year's 4-percent growth rate, which was the lowest in 20 years. If international commodity prices remain weak, we expect only a marginal improvement in growth in 1987.

New Measures Ahead

We expect Prem to stick with his unpopular austerity program for the near term, despite public discontent and squabbling within his coalition about economic policies. We believe Finance Minister Sommai—the architect of the austerity program—is unlikely to be ousted because he retains the support of Prem and the palace, and belongs to no political party. Even if Prem replaced him, a variety of reporting indicates that Prem's other economic advisers advocate similar policies. In fact, they would probably urge additional belt-tightening measures over the next two to three years—a course that would be supported by the IMF.

Bangkok, in any case, is likely to consider additional politically controversial measures to reduce Thailand's need to borrow abroad and to boost export earnings. Reforms to reduce the budget deficit—which reached $1.9 billion last year—probably will focus on cutting subsidies to state enterprises, broadening the tax base and improving tax collection, and restructuring interest rates. 25X1

If fully implemented, we believe these measures—advocated by the World Bank—probably would greatly ease Thailand's debt management difficulties. Reducing the budget deficit, for example, could lead to a drop in private as well as government borrowing abroad because fewer private-sector borrowers would be "crowded out" of domestic capital markets. A reduction in real interest rates—among the highest in the world, according to the US Embassy—also would weaken the incentive among many Thai borrowers to seek cheaper loans abroad. 25X1

Progress probably will be slow because of stiff opposition from influential interest groups. Bangkok has already been forced to modify a tax-restructuring package recently approved by the cabinet. 25X1 Efforts to privatize some state enterprises—such as the Communications Authority of Thailand—also have stalled because Bangkok is reluctant to provoke the unions—or the military officers who sit on boards of directors. 25X1 25X1

Rescheduling Prospects

If Prem remains in office until the end of his term in 1987—which we believe is likely—Thailand will probably avoid a rescheduling. We believe his government's economic policies—especially the austerity budget, a more realistic exchange rate, and the refinancing effort—combined with lower world interest rates will ease Bangkok's payment difficulties. Moreover, foreign exchange reserves—$1.9 billion at the end of 1985—provide about 2 months' import coverage, and Thailand retains access to foreign credit on favorable terms. 25X1 25X1

Thailand: Balance of Payments, 1980-85

Million US $

	1980	1981	1982	1983	1984	1985 [a]
Current Account	−2,070	−2,569	−1,006	−2,874	−2,108	−1,700
Merchandise trade	−1,903	−3,022	−1,571	−4,092	−2,862	−2,700
Exports, f.o.b.	6,449	6,902	6,835	6,308	7,338	6,900
Imports, c.i.f.	8,352	9,924	8,406	10,400	10,200	9,600
Net services and transfers	−167	453	565	1,218	754	1,000
Of which:						
Interest payments	964	1,471	1,563	1,475	1,769	1,760
Capital account	2,044	2,479	1,443	2,126	2,562	1,600
Of which:						
Direct investment	187	288	188	348	406	325
Errors and omissions	−180	133	−521	587	62	620
Overall balance	**−206**	**43**	**−84**	**−161**	**516**	**520**

[a] Estimated.

25X1

Unless there is a major export setback because of a severe global recession or an upsurge in protectionism, we believe the debt service ratio will probably rise no more than 3 or 4 percentage points before beginning a gradual decline by the end of the decade. We estimate that foreign debt service payments will grow at only 6 percent per year through the late 1980s—about half the annual rate during the first half of the decade. This assumes new public-sector borrowing of about $1 billion annually, a slight contraction of private-sector foreign debt, and growth in export earnings averaging at least 4 percent per year.

The uncertain domestic political situation clouds this optimistic forecast. If Prem is turned out of office, his successor might abandon the current government's conservative financial management. Less likely would be a marked softening of the austerity program resulting from growing demands by interest groups in business or the military, or a series of coup attempts that might lead foreign bankers to abruptly withdraw Thailand's commercial lines of credit.

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World Steel Market: The Competitive Situation Changes [redacted] 25X1

Dollar depreciation over the past year has wiped out the cost advantage of Japanese and EC steel producers over the US steel industry. For large mills in the EC and Japan, production costs expressed in dollars have increased about 25 percent from a year ago while the US industry's costs have registered a small decline. For steel landed in the US market, EC producer costs approximate those in the United States, while Japanese steel costs substantially more. Prices for steel exported from the EC and Japan, however, have increased only moderately. Overall, Free World steel output continues to stagnate, and the considerable excess capacity still existing worldwide probably will continue to depress the market. The profit picture this year is poor, with probable losses for Japanese producers and a weakening of recent EC gains. Export sales below average cost will further aggravate trade frictions with the United States. [redacted] 25X1

The EC and Japan: Rising Production Costs

A steadily depreciating dollar pushed the dollar value of EC production costs to about $435 per metric ton of finished steel in March 1986, compared with only $355 twelve months earlier, [redacted] Japan's production costs for steel increased even more, from about $400 per ton last year to $500. Meanwhile, production costs in the United States have declined moderately to about $525 per ton. Since it costs approximately $70 per ton to ship steel from either Europe or the Far East to the US market—including duty payments—EC steel now costs about the same in the United States as the domestic product, and Japanese steel about 10 percent more. A year ago foreign steel held a 10- to 20-percent cost advantage over US steel. [redacted] 25X1 25X1

The impact of foreign currency appreciation on both EC and Japanese steel production costs is mitigated considerably by the fact that about 40 percent of their total costs are imported materials purchased for dollars and unaffected by the falling dollar. Moreover, world market prices for the most important of these materials are declining. [redacted] 25X1

Japanese Versus EC Steel Production Costs

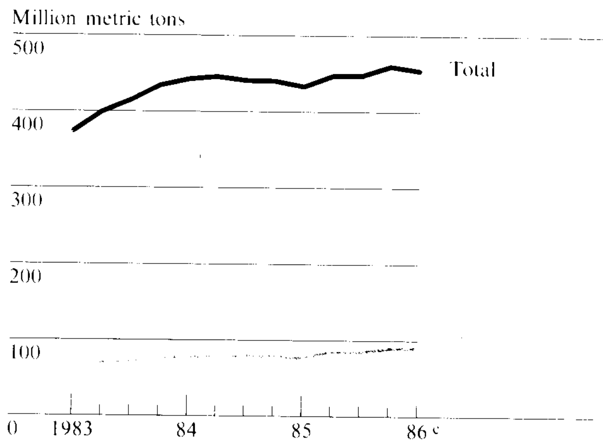
Converted to dollars, Japanese steel production costs are considerably higher than those of the EC even though the Japanese have the world's most efficient steel industry in terms of real inputs per ton of product. In 1979, before the long dollar appreciation began, steel industry analysts estimated that production costs in the large Japanese mills were $100 per ton lower than in the EC. Subsequently, costs fell in the EC while they rose in Japan. This happened in part because the EC industry shut down its highest cost mills and trimmed overstaffing elsewhere. At the same time, the Japanese mills had a hard time trimming excess labor because of lifetime employment guarantees. The main reason for the change in relative steel production cost, however, has been the strength of the yen against almost all currencies except the US dollar. From 1979 through early 1986, the yen's value approximately doubled relative to the main EC currencies. [redacted] 25X1

Export Prices Lag Rise in Costs

Prices for steel exported to the United States and to the rest of the world market have increased very little from the low levels of recent years despite the sharp rise in production costs. For example, as of early April, European spot export prices for cold rolled sheet, the major flat rolled product, were only about 10 to 15 percent above last year's low 25X1 point and only 5 to 10 percent above the level prevailing at the beginning of 1985. [redacted]

Inadequate price performance reflects a continuation of the basic weaknesses that have plagued the world steel market for a decade. After recovering from the 1981-82 downturn, steel production in the West has stagnated. Moreover, in 1985 only 70 percent of total steelmaking capacity was utilized, and most analysts see little prospect of improvement in 1986. Other forces also are hurting prices. The US import restraint program is gradually reducing steel imports, forcing some steel out of the premium-price US market and increasing the competitive pressure in other export outlets. At the same time, China also has reduced its steel imports because of port congestion and foreign payments problems. [redacted]

Free World Crude Steel Production [a] 25X1



25X1

[a] Quarterly production at seasonally adjusted annual rates.
[b] Including South Africa.
[c] Estimated.

[redacted] 25X1

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Dim Outlook for Profits

We believe the financial performance of most steel companies in the EC and Japan is threatened unless greater price increases are achieved. Not only is dollar depreciation cutting their export earnings, but their domestic profits are also being weakened. Faced with reduced earnings and markets abroad, exporters have shifted some steel into the home market, weakening domestic prices—an effect reinforced by increased import competition due to the weaker dollar. We believe the EC is particularly vulnerable to these pressures, and trade reports indicate that domestic prices for flat rolled steel have declined significantly as the dollar has fallen, despite a firm domestic market. [redacted] 25X1

The profit outlook in Japan is deteriorating badly as domestic steel prices—at a 10-year low—reinforce other negative factors. According to press reports, the major Japanese producers are forecasting losses for 1986 if the yen remains below 170 to the dollar. Shipments to both the United States and China are expected to decline, and prices will remain low. In addition, imports are rising, and the domestic market is weakening as economic growth slows. [redacted] 25X1

In the EC, the profit outlook is somewhat better because of the industry's successful efforts to cut costs by closing its less efficient operations and to reduce excess labor in its remaining mills. As a result of these measures, the EC steel industry's financial performance in 1985 was the best in many years. Financial reports suggest that aggregate losses probably were the lowest since the steel crisis began over a decade ago. British Steel, one of the large chronic losers, achieved a profit in 1985 for the first time in 10 years. Now these gains appear to be in some jeopardy, however, and industry leaders are indicating their fear that reduced exports to the United States, lower prices, and increased import competition will cause a setback in financial performance this year. [redacted] 25X1

Longer Term Prospects

We see little prospect for improvement in prices or profits for some years. Production in the Free World is probably near the peak for this cycle, and some downturn is probable during the next few years. Within this period, capacity utilization will remain low despite continued scrapping of high-cost operations in Europe, Japan, and the United States. Under these conditions, steel producers will face an uphill struggle to get higher prices. Steel sold in the highly competitive export market will continue to be priced substantially below average cost, sustaining pressure on the US steel industry and continuing to aggravate trade frictions among the major steel-producing countries. 25X1

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Briefs

Energy

London Announces New North Sea Licensing Round

London's decision to go ahead with a new offshore exploration licensing round is intended to maintain confidence in the future of North Sea production and protect the viability of the offshore service industry. The new bidding round, to be held later this year, will concentrate on areas with known gas reserves to minimize the chance the round will not attract many bidders. In addition, London will not auction any of the blocks for cash, so that smaller companies presently strapped for cash because of low prices will be able to participate. The offshore service industry has been hit hard because the number of operating rigs is 35 percent below previously forecast levels and expected to fall even further during the summer. In order to prevent further damage to the service industry, Energy Minister Buchanan-Smith hinted last week of government actions to reduce cuts in North Sea development. The minister indicated that London might reduce the tax rate on new production from enhanced development of existing fields, a move that would spur development.

25X1

25X1

International Finance

Honduran Debt Talks

Negotiations to reschedule Honduras's officially guaranteed private debt have resumed, seven months after talks were broken off. This debt to commercial banks totals $226 million, including approximately $150 million in overdue principal, according to Embassy and press reporting. Meanwhile, Tegucigalpa is largely current on the balance of its total $2.4 billion debt. Bankers are no longer insisting on an IMF agreement as a precondition for rescheduling, according to the US Embassy. Nevertheless, bankers have rejected Tegucigalpa's request for new money, called for immediate payment of $15 million in overdue interest, and demanded shorter payback periods than Honduras is seeking. The Hondurans are calling for limits on official guarantees for the new agreement, and interest rates and rescheduling fees well below those proposed by bankers. Despite the retreat on the IMF program precondition, prospects for a quick settlement are remote because of the wide divergence in negotiating positions, and because Honduras lacks the foreign exchange needed to clear the interest arrearages. [redacted] 25X1

Egypt's Financial Position Concerns Foreign Bankers

Foreign bank creditors are increasingly concerned Egypt will be unwilling to adopt domestic economic policy adjustments—which Cairo considers politically risky—to offset sharply declining oil export revenues, and many bankers expect Cairo will need a debt rescheduling within 12 months, according to a reliable source and US Embassy reporting. According to the US Embassy, economic reforms recently announced by Cairo offer almost no hope of narrowing Egypt's 1986 foreign payments gap—estimated by the IMF and World Bank at roughly $4 billion. Concern over Egypt's shaky financial position has led a growing number of foreign banks to reduce their credit lines to the country. [redacted] 25X1 An IMF team that is to visit Egypt early this month to conduct annual Article IV consultations also will explore the possibility of a standby arrangement. [redacted] 25X1

International Trade

Thailand To Raise US Farm Act With GATT

Thai economic ministers decided on 21 April to complain in the GATT of unfair US trade practices resulting from the rice provisions of the Farm Act. Bangkok would demand US compensation for damage to Thai rice export earnings; export proceeds from the compensation would then be used to support the domestic price of rice. The US rice export price initially set under the Farm Act was lower than that which Deputy Prime Minister and Foreign Minister Siddhi had publicly indicated would be acceptable. This has embarrassed Siddhi and his Social Action Party, which has long advocated price supports for domestic rice and which provides nearly all of the key economic ministers in the governing coalition, including those for agriculture and commerce. [redacted] 25X1

Global and Regional Developments

25X1
[redacted]

[redacted] 25X1

More Chips From Malaysia

In an effort to maintain its share of the US market, Toshiba announced on 28 April it will increase production of 256K dynamic random access memory (DRAM) chips from both its Malaysian and West German affiliates to substitute for shipments from Japan [redacted] this 25X1 move is the result of a provisional Commerce Department decision in March that Japanese 256K DRAMs were being sold in the United States at less than fair prices. Toshiba Electronics Malaysia will increase its production to 1 million chips per month by fall. Even this boost of less than 1 percent in chip production will be a welcome development, with Malaysian chip output down 26 percent in 1985 and employment in the industry down 22 percent over the last two years. [redacted] 25X1

National Developments

Developed Countries

[redacted] 25X1

25X1

UK Trade Deficit Sets Record

Britain's trade deficit hit a record in March, the result of a sharp drop in the oil trade surplus and a widening nonoil trade deficit. The oil trade surplus fell $432 million in March as a result of a 20-percent fall in the price and a 23-percent decline in export volume. The poor trade performance pushed the March current account into deficit for the first time in a year. Although the current account registered a $1.3 billion surplus for first quarter 1986, last month's poor performance makes it unlikely that the $5.2 billion surplus forecast for the year can be attained. A declining trade performance is especially disappointing because the pound's effective exchange rate has made Britain's export competitiveness better than at any time in the past decade. 25X1

Italian Gasoline Tax Offsetting Other Revenue Declines

The excise tax levied on refined petroleum products in February—in the wake of falling oil prices—is likely to more than offset a decline in value-added tax (VAT) revenues. VAT collections fell by 1.6 percent in February as the drop in the dollar lowered many Italian import prices. While Finance Minister Visentini does not anticipate any revenue shortfalls this year—despite the lower VAT revenues and recent measures in the 1986 budget that adjust income tax rates for inflation—he cautioned against any new tax reductions this year. Moreover, he is likely to argue that the extra petroleum excise revenues—possibly $500 million—do not provide sufficient leeway to fund additional public spending. 25X1

VAT Impact on Spanish Prices Less Than Expected

Inflation figures for first quarter 1986 indicate that, despite implementation of the new value-added tax (VAT) on 1 January, Spanish prices are unlikely to rise as high as anticipated by government and private economists. Although the VAT rate is 12 percent for most consumer goods, the consumer price index (CPI) jumped only 2.8 percent in January, about 3 points below economists' most pessimistic predictions. Helped by a declining dollar, lower oil prices, and falling interest rates, the CPI rose only 0.4 percent in February and 0.5 percent in March—bringing the 12-month inflation rate to 8.7 percent, 0.6 point above the 1985 rate. Madrid is especially encouraged by the results as it prepares for a general election in June. Although the government will have to continue contractionary policies to achieve its inflation goal of 8 percent this year, Madrid can postpone for the time being contingency plans for restrained monetary growth and higher interest rates. [redacted] 25X1

25X6 [redacted]

Less Developed Countries

[redacted] 25X1

Iranian Belt-Tightening

Prime Minister Musavi announced last week that nonmilitary expenditures will have to be reduced to maintain the war effort. [redacted] 25X1 Assembly Speaker Rafsanjani publicly acknowledged last week that Iran faces economic problems this year. This is the first time Iran's leaders have admitted that the economy is deteriorating; the statements probably are intended to prepare the public for a further decline in living standards. Tehran probably will have to reduce imports by at least 20 percent this year, with most of the burden falling on industry and on civilian construction. Food and military imports are unlikely to be affected in the next few months, but shortages of consumer goods will probably increase. Tax increases and layoffs of government workers are almost certain. Over the longer term, Iran will be unable to maintain both its war effort and current levels of food imports unless it can increase oil export revenues. [redacted] 25X1

Pakistani Response to Lower Oil Prices

The government may try to raise crude oil imports to take advantage of lower world oil prices. [redacted] Pakistan planned earlier 25X1 this year to import roughly 75,000 b/d, up from 74,000 b/d in 1985, from Saudi Arabia, Iran, and Abu Dhabi. The bulk of the projected purchases were on a netback arrangement, which pegged the price of the crude oil to the price of products refined from it. The US Embassy reported that, although Pakistan increased its imports in January and February, it is not passing the savings on to consumers, probably to reap windfall tax revenues and to forestall large increases in consumption. Lack of storage capacity may inhibit large increases in imports, but the lower prices should help ease the current account deficit this year. The government probably also will attempt to renegotiate prices on its oil agreements with Tehran and Abu Dhabi, or turn to the spot market to meet increased needs. [redacted] 25X1

Communist

Economic Impact of the Chernobyl' Nuclear Accident

The extent of economic disruption depends on the extent of area affected and the degree of contamination. On the basis of the likely path of radiation dispersal, the potentially affected areas contain a sizable portion of Soviet livestock herds, winter wheat, and sugar beets. The winter grain crop will not be harvested until July. Consequently, unless contamination is severe, the impact is likely to be limited. Cattle and hogs, for example, could use stored feed for some weeks. Because Chernobyl' is located on Kiev's watershed, the 2.4 million people in Kiev, as well as those in other nearby urban centers, could be affected by both air- and water-borne radioactivity. The Soviets have reported [redacted] that the entire Chernobyl' plant 25X1 has been shut down. This will seriously affect the electricity supply to key industries in the Ukraine—metallurgy, chemicals, and machine building. Moscow could try to compensate by increasing power output at fossil-fuel plants and selectively rationing electricity, but shortages for key consumers remain likely. Electricity exports to Czechoslovakia, Romania, and Poland also are likely to be reduced temporarily. The reactor damaged at Chernobyl' is not the type the Soviets now export to Eastern Europe and are trying to sell outside the Bloc, but Moscow's export plans will probably be affected by the unfavorable publicity. [redacted] 25X1

Strong Soviet Industrial Growth

Total industrial production in the first quarter—estimated from Soviet statistics just released—was more than 6 percent higher than in the first quarter of 1985. Much of the increase represented a rebound from last year, when the coldest winter in two decades disrupted production. Part of it is also the result of General Secretary Gorbachev's exploitation of "hidden reserves": increased labor productivity through improved discipline, reduced waste, and in some instances reduced costs. Growth in machinery—the key sector for Gorbachev's modernization program—was up nearly 7 percent over the same period of 1985. Growth was particularly strong in machine tools and computers. Output of basic materials—metals, chemicals, concrete, and timber—also surged, more than compensating for last year's setbacks. Even if the growth of the machinery sector this quarter is sustained, however, it probably will not be sufficient to achieve the increase in investment planned for this year. The greater basic materials output is a hopeful sign in an area Soviet officials have blamed for bottlenecks and slow industrial growth in recent years. 25X1

25X1

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